United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

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75-7424

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UNITED STATES COURT OF APPEALS

for the

SECOND CIRCUIT

VINCENT K. HILTON and EDWARD G. HILTON, as Trustees under Indenture dated May 9, 1958 for the benefit of VINCENT K. HILTON; VINCENT K. HILTON and EDWARD G. HILTON, as Trustees under Indenture dated May 9, 1958 for the benefit of MARY G. HILTON; and EDWARD G. HILTON,

Plaintiffs-Appellants,

against

BROWN BROTHERS HARRIMAN & CO., et al.,

Defendants,

FIRST NATIONAL CITY BANK,

Defendant-Appellee.

APPEAL FROM UNITED STATES DISTRICT COURT,
SOUTHERN DISTRICT OF NEW YORK

BRIEF FOR PLAINTIFFS-APPELLANTS

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BRIEF FOR PLAINTIFFS-APPELLANTS

Preliminary Statement

The decision below was rendered by Hon. Marvin E. Frankel, United States District Judge. His decision is not reported.

The Issues Presented For Review

If a check payable to the order of a trustee "et al." is deposited on the endorsement of one of the three trustees in an account of the one trustee's corporation, which deposit constitutes a misappropriation by the one trustee, is the depositary bank put upon inquiry as to the propriety of the deposit? And if the depositary bank fails to make any inquiry, is it liable to the trust for the loss suffered as a result of the misappropriation?

Statement of the Case

The action arises out of the misappropriation by a co-trustee, James S. Bush, of assets belonging to two trusts. The action was commenced by the trusts against Bush, against a corporation of which he was principal (Inter-Mundis Capital Services Limited - herein called "Inter Mundis"), and against 2 brokers and 3 banks, all of which were alleged to have aided the misappropriation. The action was settled as to the brokers and 2 of the banks (Brown Brothers Harriman & Co., J.S. Love & Company, Inc., Bacon, Stevenson & Co., and United States Trust Company of New York). Bush disappeared before commencement of the action and was never served. Inter Mundis was served, but it had ceased doing business and defaulted in appearing, and judgment by default was entered against it (paragraph 2 of the judgment appealed from -

A20-A21*). The sole remaining defendant was First National City Bank (herein called Citibank, and elsewhere in the papers sometimes referred to as FNCB), and the issues as to it were submitted to the District Court upon a Stipulation as to Facts.

By amendment to each trust indenture, Bush had been authorized by the then trustees "* * * to act alone as Trustee, as aforesaid, and to exercise the powers vested in the Trustees without obtaining the concurrence of any one or more of the Trustees at any time acting under said trust agreement* * *." (A10). In 1969, Bush misappropriated over $300,000.00 worth of bearer municipal bonds belonging to the trusts; this conduct, in which Brown Brothers Harriman & Co., United States Trust Company of New York, J.S. Love & Company, Inc., and Bacon, Stevenson & Co. were alleged to be involved, was the subject of counts First through Twelfth of the Amended Complaint, and the action has been settled as to those counts.

On March 12, 1971, each of the trusts owned 500 shares of Midland Ross Corporation, which were sold on that date by stockbroker Bacon, Stevenson & Co. at the direction of Bush. Bacon, Stevenson & Co. gave Bush 2 checks for the net proceeds of the sales, each for $15,072.93, drawn on Citibank and payable to the Trustees. Bush endorsed the checks for deposit to the account of

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* "A" refers to pages of the Appendix.

Inter Mundis maintained with Citibank, and the checks were so deposited. (A10 - A11.)

Inter Mundis was a corporation of which Bush was president. It was not entitled to the funds represented by the checks, and the endorsement and deposit of them was not authorized. Thereafter, Inter Mundis disbursed all the funds in its account, but the trusts received none of the funds. Bush disappeared. (A11.)

Citibank took the checks for deposit without making any inquiry; it knew nothing about the trusts. (A12.)

The trusts claimed in counts Thirteenth through Twenty-Seventh against Brown Brothers Harriman & Co. (which as custodian for the trusts had delivered out the stock), Bacon, Stevenson & Co. (the broker), Citibank, Inter Mundis and Bush. As noted, settlement was reached with Brown Brothers Harriman & Co. and Bacon, judgment by default was entered against Inter Mundis, and Bush was never served. Counts were alleged under the Securities Acts and other statutes and upon theories of fraud, breach of contract and negligence. We are concerned on this appeal only with counts Twenty-Sixth and Twenty-Seventh, which allege that the conduct of Citibank renders it liable to the trusts upon theories of conversion and money had and received (A6).

Jurisdiction exists as between plaintiffs and Citibank on the ground of diversity.(A9)

ARGUMENT

Summary

One of the checks involved here is drawn to the order of "James S. Bush et al u/t/a/5/9/58 F/B/O Vincent K. Hilton"; the other is drawn to the order of "James S. Bush et al Trustees u/t/a 5/9/58 Mary Grimes Hilton" (A14, A15). Presumably "u/t/a" means "under trust agreement". When these checks were tendered to Citibank for deposit to the account of a corporation which had no connection with the trusts, Citibank had a duty to inquire as to the propriety of the deposit (Point I). The failure of Citibank to make any inquiry renders it liable to the trusts for the loss they suffered (Point II). Citibank's liability can also be based upon its failure to obtain a full endorsement, by the 3 trustees, of the checks (Point III).

We conclude with an analysis of the opinion below (Point IV).

Point I

Citibank had a duty to inquire as to the propriety of the deposit of the checks belonging to trusts in the account of a third person - Inter Mundis.

We note, initially, that this is not a case where trust funds are deposited by a trustee in his own account with a bank. In such a situation, the bank may well be protected as a holder in

due course under statutory law. This case is one where trust funds are deposited by a trustee in the account of a third person (Inter Mundis) having no connection with the trusts; indeed, the bank here knew nothing about the trusts. We submit that in this situation, the bank had a duty of inquiry.

No authority directly in point has been found.

1. The common law applicable.

It is stated in Scott on Trusts (3rd ed.) pp. 2418-2422:

"§297.6. Negotiable instruments. The general principal that where a trustee in breach of trust transfers property to a person who has notice of the breach of trust the transferee takes subject to the trust, is applicable, of course, to negotiable instruments.

* * *

"Where the name of the holder of a negotiable instrument is followed by the word 'trustee' or other words indicating a fiduciary character, the question arises how far a transferee of the instrument is bound to make inquiry as to the existence of a trust and as to the extent of the powers of the holder.

* * *

"But where the fiduciary character of the transferor appears on the face of the instrument, it is held by the

weight of authority that the transferee is bound to make inquiry as to the authority of the transferor. It is held that the rule as to what constitutes notice stated in §56 of the Negotiable Instruments Law, that actual knowledge or bad faith is essential to notice, is not applicable where the fiduciary character of the transferor appears on the face of the instrument. The transferee is not a holder in due course if the transferor does not use due diligence to inquire into the authority of the transferor to negotiate the instrument."

Scott notes that under the Uniform Fiduciaries Act § 4 *, it is provided that, if a negotiable instrument is payable to a fiduciary, an indorsee is not bound to inquire whether the fiduciary is committing a breach of duty in transfering the instrument. He notes further that

*§4. Transfer of Negotiable Instrument by Fiduciary. - If any negotiable instrument payable or indorsed to a fiduciary as such is indorsed by the fiduciary, or if any negotiable instrument payable or indorsed to his principal is indorsed by a fiduciary empowered to indorse such instrument on behalf of his principal, the indorsee is not bound to inquire whether the fiduciary is committing a breach of his obligation as fiduciary in indorsing or delivering the instrument, and is not chargeable with notice that the fiduciary is committing a breach of his obligation as fiduciary unless he takes the instrument with actual knowledge of such breach or with knowledge of such facts that his action in taking the instrument amounts to bad faith. * * *"

while that Act was not adopted in New York, there was a similar provision contained in the New York Negotiable Instruments Law, but that this was repealed by the adoption of the Uniform Commercial Code.

In 11 Am Jur 2d, Bills and Notes §463, the following is stated:

> "Except as statutes provide otherwise, one dealing with an issuer or holder of commercial paper with actual knowledge or constructive notice that such person is an agent or trustee for another must inquire into the authority of the agent or trustee - that is, he must use reasonable diligence and prudence to ascertain whether the agent or fiduciary is acting and dealing with him within the scope of his powers - as in other cases of agency, trusteeship, or other fiduciary relationship."

And in §465, ibid., it is stated:

> "The cases here discussed establish that with some variations the appearance upon an instrument of words indicating a representative or fiduciary capacity constitutes constructive notice and imposes a duty of inquiry by a person taking the instrument."

We submit, therefore, that under the common law relating to trusts and negotiable instruments, Citibank, when it

took the checks for deposit to the account of Inter Mundis, was on notice of a possible breach of trust being committed by Bush. The application of this law to the instant case finds support by analogy in the line of cases next discussed.

2. Authorities in the closely analagous situation where trust funds are made available to third persons.

In the situation discussed in this portion of the brief, trust funds were not deposited directly in an account of a third person, but were made available directly to the third person. The analogy is clear - the two checks here, payable to the trusts, were made available to the third person (Inter Mundis) by deposit in its account. In such situation, the bank has been held liable for the misuse of funds.

In Lee v. Corn Exch. Bank Trust Co., 270 App. Div. 2 (2nd Dept., 1945) affd. wo. op. 295 N.Y. 945 (1946), Johnson drew funds from an estate account with defendant of which he was executor, and deposited them in his personal account. His wife withdrew amounts from the personal account under a power of attorney from him. The Court held (pp. 4-5):

> "By paying the checks drawn by the executor's wife on February 15, 1938, as well as some three hundred additional checks thereafter, the defendant became a participant in the diversion. The bank, having had notice on

February 17, 1938, that the funds of the estate were being withdrawn by a stranger to the estate, is responsible for all estate funds thereafter misappropriated by the executor. (Bischoff v. Yorkville Bank, 218 N.Y. 106, 113, 114.)

* * *

"But although a bank may, in the absence of adequate notice to the contrary, assume that an executor or trustee will properly apply trust funds, even though they may have been improperly commingled, it may indulge in no similar assumption as to the disposition to be made of such funds by a complete stranger to the estate who has access to the executor's personal account."

In the case at bar, the deposit of the checks belonging to the trust in the account of Inter Mundis meant that the trust funds were being disposed of by a stranger.

In Grace v. Corn Exchange Bank Trust Co., 287 N.Y. 94 (1941), the Court held a bank liable for trust funds used by a trustee to pay his personal obligations and those of his corporation to the bank.

In Newton v. Scott, 254 App. Div. 140 (4th Dept. 1938), where, among other things, a committee of two incompetents took funds of one and deposited them in the account of the other to cover

an overdraft, the Court held the bank of deposit of both accounts was put on inquiry as to the propriety of the use of the funds, so as to justify a "submission to a jury of the question of fact whether the depositary performed the duty required of it."(P. 147)

Point II

The failure of Citibank to make inquiry renders it liable to plaintiff trusts for their loss of the checks.

We have argued above that in the case at bar the authorities require a holding that Citibank was on notice of the misappropriation of trust funds belonging to plaintiff when it accepted the two checks for deposit.

The authorities indicate further that the failure of one who is on notice to make inquiry, imposes on him absolute liability if there is an actual misappropriation, as here. Again, no authority directly in point with the present fact situation (deposit by a trustee of trust funds in a third person's account) has been found, but the authorities indicate the previous sentence to be the rule wherever a bank is chargeable with notice of a diversion of trust funds.

In Wilson v. M.E.R.Co., 120 N.Y. 145 (1890), plaintiff sued on a note made by defendant corporation to its own order which was indorsed by the president of the corporation to plaintiff to cover the president's own debt. The Court held that plaintiff was

on notice that the president was using corporate assets for his own benefit, and had the "burden of inquiry" (p. 152) as to whether issuance of the notes was authorized. The Court stated at page 150:

> "Undoubtedly the general rule is that one who receives from an officer of a corporation the notes or securities of such corporation, in payment of, or as security for, a personal debt of such officer, does so at his own peril. Prima facie the act is unlawful, and, unless actually authorized, the purchaser will be deemed to have taken them with notice of the rights of the corporation (citing authorities)."

As stated in 41 N.Y.Jur. Negotiable Instruments §363, p. 567:

> "Such a person [e.g. one who takes a check endorsed by a trustee in payment of the trustee's own debt] took subject to the defense of the person or entity represented that there was an unauthorized execution of the instrument and subject to the principal's claim to the funds represented by an instrument which had been negotiated without, or in excess of, the representative authority."

And again, in 5A N.Y.Jur. Banks and Trust Companies, §471, pp. 220-221, the statement is:

> "But the bank, knowing funds in the fiduciary's individual

account to be trust funds, renders itself liable if it participates in the fiduciary's diversion of them from trust purposes."

Suppose Citibank had made inquiry. What would it have discovered? An inquiry of Bush alone would have been impermissable. Thus, in the case of Ward v. City Trust Co., 192 N.Y. 61 (1908), where defendant bank took a check payable to a corporation in satisfaction of a debt owed by the corporation's officers, Umstead and Kiefer, the Court held that the bank had a duty of inquiry as to the propriety of such application of the corporate funds, and that (p. 71):

> Inquiry of Umstead and Kiefer would not have satisfied the requirement, for it was apparent that they were acting in their own interest and, hence, beyond the general scope of their authority."

Citibank knew Bush was President of Inter Mundis and owned stock in it (A16). Citibank would have gone to the Hiltons themselves. This would, of course, have revealed Bush's misappropriations; we don't think the Hiltons would have said to Citibank: "Don't worry, let Bush pay the trust funds to anyone." We don't think Citibank would ever have seen, or asked to see, the trust indentures. Perhaps Citibank would have found that Bush had disappeared (A11), perhaps Citibank would realize that Inter Mundis owed it - Citibank - a substantial sum (A12), perhaps it would appear

that Inter Mundis was out of business and bankrupt (this we don't know, but all indications point to it). As stated in Bischoff v. Yorkville Bank, 218 N.Y. 106, 114 (1916), a bank, having the duty to make inquiry as to the possible diversion of trust funds:

> "* * * was charged by the law to take the reasonable steps or action essential to keep it from paying [the misappropriating executor] as his own the moneys which were not his and were the executor's, and was bound by the information which it could have obtained if an inquiry on its part had been pushed until the truth had been ascertained." (Underlining added)

In short, had Citibank made proper inquiry, it would have discovered Bush's misappropriation.

Point III

Citibank is liable to Plaintiffs for having taken checks payable to three persons with the endorsement of only one.

This point relies on U. C. C. §3-116, which provides:

> "An instrument payable to the order of two or more persons
>
> (a) if in the alternative is payable to any one of them and may be negotiated, discharged or enforced by any of them who has possession of it;
>
> (b) if not in the alternative is payable to all

of them and may be negotiated, discharged or enforced by all of them."

Failure of all the payees to endorse, when the check is not payable in the alternative, subjects the depositary bank to liability thereon. Edwards Company, Inc. v. Long Island Trust Company, 75 Misc. 2d 739 (Sup.Ct. 1973).

Here the check for one trust was payable to the order of "James S. Bush et al u/t/a/5/9/58 F/B/O Vincent K. Hilton" (A14). The check for the other trust was payable to the order of "James S. Bush et al Trustees u/t/a 5/9/58 Mary Grimes Hilton" (A15). Obviously the "et al" on each check referred to the two trustees other than Bush, then acting. Only Bush endorsed the checks.

It cannot be argued at this point that Bush's sole endorsement was sufficient because he had authority to act alone. As a matter of elementary trust law, the entire authority of Bush as a co-trustee obviously did not include authority to misappropriate the trust assets, alone or otherwise, and that is what his endorsement and related conduct attempted. While in certain situations a third party might rely on authority given a co-trustee in a trust instrument, in order to invoke an estoppel or related defense, here Citibank had no knowledge whatsoever of the trust instruments or of Bush's authority or lack thereof.

The checks showed on their face that they belonged to Bush and others, and when Citibank took them with the endorsement of Bush alone, it failed to have proper negotiation thereof under U. C. C. §3-116. Accordingly Citibank cannot adopt the stance of holder in due course, it still holds for the trusts the funds represented by the checks, and its failure to pay over the funds renders it liable to the trusts.

We note at this point that it can be argued that the description of the payees of the checks - "James S. Bush et al" etc. - and the single endorsement by Bush, in itself should have put Citibank on notice so as to call for inquiry on its part as to the authority of Bush. This argument adds to the weight of Point I above.

Point IV

Analysis of the Findings and Conclusions below.

We indent and quote from the Findings and Conclusions below, with comment following each portion quoted.

> "By stipulation dated January 2, 1975, the parties have agreed upon the facts from which plaintiffs claim defendant First National City Bank is liable to them in the amount of $83,586.91." (All quotations from the Court below are at A18.)

Comment. The District Court took the figure set forth in the Amended Complaint when claim was being made against Citibank on all the counts Thirteenth through Twenty-Fifth, which included claims for attorney's fees and punitive damages (A6). However, plaintiffs had previously settled out all counts except the Twenty-Sixth and Twenty-Seventh, and all plaintiffs requested below was judgment on the latter two counts for the amount of the checks (see Conclusion on page 9 of plaintiffs' Memorandum below).

* * *

"The facts so stipulated are incorporated herein as the court's findings. Upon the facts thus determined, plaintiffs' claim against said bank should and will be dismissed."

No comment.

* * *

"Applying the law of New York, which is agreed to cover the case, the court finds no basis for plaintiffs' claim. As an original proposition, it is scarcely appealing to urge that the settlor-beneficiaries, having delegated to the malefactor the power to act for them and having shed even minimal responsibility to look out for themselves, should be made whole by a bank, lacking knowledge even of the trusts' existence, for the routine honoring of its customer's checks."

Comment. This argument would exonerate any bank or other entity which aided a malefactor trustee in stealing trust assets. Thus, it can be said that whenever settlors appoint a sole trustee, the settlors have "delegated to the sole trustee the power to act for them and have shed even minimal responsibility to look out for themselves." When the Hiltons here delegated the authority to Bush to act alone, it was as if he had been designated sole trustee; the Hiltons could have done this when the trusts were set up; what difference can it make that they did it at a later time? And when the settlors have so delegated and so shed responsibility, can a bank dealing with the "sole" trustee ignore the rules applicable to trusts and trust assets and, by shutting its eyes to a clearly suspicious appropriation of trust assets, claim lack of liability? We think not. Nor does it help to say that this was a "routine" honoring of a customer's checks. This begs the question, which is : was the honoring of the checks involved here by taking them for deposit in the account of a third person corporation done under circumstances requiring the bank to make inquiry, or was it "routine"?

* * *

> "In any event, though there be no case squarely in point, the authorities reviewed in the briefs reflect principles defeating plaintiffs' claim."

Comment. With genuine respect for the learning and ability of the Court below, we would have appreciated a statement of what authorities stood for what principles.

* * *

"There was no such duty of inquiry as plaintiffs propose."

Comment. The authorities set forth in Point I above show that there was such a duty. If the Court is to make new law, it should so state.

* * *

"The signature of Bush, fully authorized, was ample to negotiate the checks."

Comment. Bush was not authorized to misappropriate or steal the checks, anymore than any sole trustee may steal trust funds.

* * *

"Had the bank asked about that, it would have learned only that the course it took was proper."

Comment. What possible persons could the bank have asked? Bush, no this would not be permissable - see Point II above. Inter Mundis, no this was Bush. Bacon, Stevenson & Co., the drawer of the checks were simply the brokers, and obviously knew nothing about who was entitled to the trust funds. The Hiltons, yes, and the misappropriation would have been discovered. In short, as stated in Bischoff v. Yorkville Bank, supra, page 14, Citibank

"was bound by the information which it could have obtained if an inquiry on its part had been pushed until the truth had been ascertained."

Conclusion.

Citibank assisted Bush in his conversion of the trust funds. Citibank had the funds, which it then made available to a third party. Clearly it is liable to the trusts on the theory of conversion set forth in the Twenty-Sixth count (A6). As to liability under Points I and II, see 10 N.Y.Jur. Conversion §43; as to liability under Point III, see Barden & Robeson Corp. v. Tompkins County Trust Co., 67 Misc.2d 587 (Sup. Ct. 1971). It would appear that the theory of money had and received set forth in the Twenty-Seventh count (A6) would also be applicable.

The relief sought from this Court is that the judgment of the District Court (A20-A21) be modified as follows: the award of judgment in favor of defendant Citibank and against plaintiffs should be stricken, and paragraph 1 of the judgment should award judgment in favor of each of the plaintiff trusts and against Citibank for $15,072.98, plus interest from March 12, 1971 and costs, less credit for amounts received by plaintiffs from others, to be calculated by the Court below; the award of costs in favor of Citibank should be stricken; the clerk of the Court below should be directed

to tax costs in favor of plaintiffs.

Respectfully submitted,

John M. Friedman

Attorney for Plaintiffs-Appellants

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